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ONE HUNDRED SEVENTH CONGRESS

U.S. House of Representatives
Committee on Energy and Commerce
Washington, DC 20515-6115

W.J. "BILLY" TAUZIN, LOUISIANA,
CHAIRMAN

January 30, 2002

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DAVID V. MARVENTANO, STAFF DIRECTOR

The Honorable Harvey L. Pitt
Chairman
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Chairman Pitt:

For a number of years, we have expressed serious reservations regarding the Commission's support for repeal of the Public Utility Holding Act of 1935 (PUHCA), as well as its permissive administration of the Act. In light of the collapse of the Enron Corporation, we are writing to ask whether the Commission has reconsidered its position on PUHCA repeal. If not, we urge you to initiate a review to determine whether the Commission's support for repealing the Act is appropriate, given what has come to light so far with respect to Enron's activities and what may yet be learned in investigations underway at the Commission and elsewhere.

While inquiries into Enron's activities are in the early stages, the parallels between the circumstances leading to PUHCA's enactment and present day events are striking. As was typical of utility holding companies in the 1920's and 1930's, Enron created a highly complex corporate structure for the apparent purpose of obscuring significant information from investors and engaging in self-dealing transactions with affiliated entities. This brings to mind the Federal Trade Commission's 101-volume 1933 report on holding company practices and this Committee's investigations under Chairman Rayburn's leadership¹, which paved the way to PUHCA's enactment by documenting abuses such as: 1) the issuance of securities based on unsound asset values, inflated capital structures, and market manipulation; 2) the exploitation of operating subsidiaries through intrasystem profiteering on transfers of assets, cross-subsidization, and financial mismanagement; 3) pyramidal corporate structures resulting in the issuance of excessively speculative securities; 4) the expansion of holding company systems without regard

¹*Report on the Relation of Holding Companies to Operating Companies in Power and Gas Affecting Control*, H.R.Rept.No. 827, 73rd Cong., 2d Sess. 658 (1935) (Also known as the "Splawn Report")

to the integration and coordination of related utility properties; and 5) the concentration of economic power not susceptible to state regulation.

Given what we have learned about Enron's operations, it is fortunate that recent efforts to repeal PUHCA without countervailing protections did not succeed. While Enron purchased one utility, Portland General Electric Company without running afoul of PUHCA, the Act appears to have made further direct investments in investor owned utilities unattractive to Enron.

As the 1995 report of the Commission's Division of Investment Management observed², section 11 of the Act "limits the ability of nonutility companies to diversify into the utility business," and doing so would have required Enron to register under the Act and divest its non-utility ventures. Absent this restriction, Enron might well have drawn more utilities into its byzantine structure, and shareholders who thought they had invested in conservative electric or gas utilities might have seen their funds disappear as the holding company declared bankruptcy. Moreover, expanded Enron ownership of traditional utilities could have compromised not only the price of electricity, but also the reliability of the grid had the company been able to gain control of critical transmission facilities.

In a December 11, 2001, article in the Wall Street Journal, you wrote that "[o]ur current reporting and financial disclosure system has needed improvement and modernization for quite some time" and that inadequate disclosure "creates the potential for a financial 'perfect storm.'" That does little to diminish our concerns about PUHCA repeal, and raises questions about the Commission's dependence on the findings in its Division of Investment Management's 1995 report recommending PUHCA repeal. In a discussion of "whether to retain any federal restrictions on diversification into and out of the utility business," the 1995 report noted:

"Of course, not every investment by a registered holding company in a nonutility business, or by a nonutility company in a utility business, will prove profitable. Indeed, ventures by exempt holding companies into unrelated businesses such as banking, drug stores and real estate have proven largely unsuccessful."

Indeed, over the last decade, a number of exempt holding companies have undertaken ambitious diversification programs, most of which were unsuccessful and some of which proved to be disastrous. Some examples are:

- * In the late 1980's, Pinnacle West Capital Corporation, the corporate parent of Arizona Public Service Corporation, lost millions following the failure of Merabank (a savings and loan owned by Pinnacle). This forced Pinnacle to issue

²*The Regulation of Public-Utility Holding Companies.*

debt at the holding company level, serviced by revenues of the operating utility subsidiary.

- * In January 1994, Pacific Enterprises agreed to pay \$45 million in settlement of shareholder lawsuits relating to the company's failed diversification into discount drug and sports equipment retailing, and oil and gas operations. The diversification efforts had absorbed \$2 billion and brought the company to the edge of bankruptcy, forcing Pacific to dispose of various nonutility assets, restructure its debt, and change its dividend.
- * In 1990, FPL Group, the parent company of Florida Power & Light Co., was forced to take a \$689 million write down for losses associated with an unsuccessful effort to diversify into cable television, insurance, and citrus fruit production.
- * In 1992, Hawaiian Electric Industries, Inc., parent of three Hawaiian utilities, was forced to write off \$63.3 million due to losses in two nonutility subsidiaries, one of them an insurance company that had proven unprofitable.

A September 1992 study of utility diversification efforts published in Public Utility Fortnightly concluded that such diversifications have proven "horrendous in the aggregate and...satisfactory to disastrous for individual utilities." This study found that the 20 utilities examined had "invested about \$6.5 billion of common equity in their diversified undertakings and sustained aggregated losses of \$387 million during the six years from 1986 through 1991." The study further noted that "the return on equity on the diversification projects averaged 1.1 percent for the six years."

Notwithstanding these cautionary examples, however, the Commission's 1995 report concluded that PUHCA repeal was appropriate in light of other systemic protections, including financial disclosure requirements:

"Investors are already protected by the disclosure required under the Securities Act and the Exchange Act. The disclosure requirements under these laws are designed to ensure that investors have the information they need *regardless of how diverse and complex the operations of a company*" (emphasis added).

While we are open to arguments about the need to update PUHCA in the context of a comprehensive bill that addresses the types of abuses that it was enacted to prevent, to the extent the Commission's case for repeal rests on the adequacy of current accounting practices, regulatory vigilance, and what you have characterized as a flawed financial disclosure system, it

would appear prudent for the Commission to reconsider its position, in light of the unfolding Enron scandal.

In particular, we are concerned that the Commission's legislative proposal, which depends solely on "books and records" requirements, would pose unjustifiable risks for both investors and electric consumers. As you know, on three occasions Congress has enacted specific exceptions to PUHCA's diversification ban, permitting registered utilities to make limited investments in independent power generation, telecommunications, and foreign utility companies. Each of these legislative exceptions included conditions on the amount of a utility's investment and requirements for state regulatory approval. While the Commission's implementation of these provisions has not been without controversy, particularly with respect to foreign utility companies, to our knowledge they have not undermined the fundamental soundness of any utility or compromised service to electric customers. The fact that the Commission's support for PUHCA repeal is conditioned only on modest "books and records" requirements, rather than more extensive protections such as those included in the three prior legislative exemptions, is troubling. Does the Commission really believe that state utility regulators will have the level of staffing, resources, and technical expertise to fully comprehend potential risks to utility ratepayers posed by corporate transactions as complex as Enron's now-infamous "special purpose vehicle" limited partnerships, as well as its myriad affiliates, subsidiaries, private placements, structured financings, and derivatives businesses?

As recently as December 13, 2001, at a legislative hearing before the Subcommittee on Energy and Air Quality on electric restructuring legislation, Commissioner Hunt testified that while "PUHCA repeal can be viewed as part of the needed response to the current energy problems facing the country," the Commission "does not have a preference as to whether the Act is repealed on a stand-alone basis or as part of broader, energy-related legislation." We disagree with this approach. If PUHCA is to be repealed or otherwise modified, it is incumbent upon Congress to carefully distinguish between provisions which may no longer be warranted and aspects of the Act which still serve a useful and necessary purpose. Additional protections along the lines of the three prior legislative exceptions may be warranted. It also may be necessary to enhance the authority of the Federal Energy Regulatory Commission (FERC) to prevent the abuse of market power under the Federal Power Act, which it is useful to remember was enacted as Part II of PUHCA in 1935.

Since H.R. 3406, an electric industry restructuring proposal which includes PUHCA repeal, may be marked up next month in the Subcommittee on Energy and Air Quality, we would appreciate a response to the attached questions by February 13, 2002:

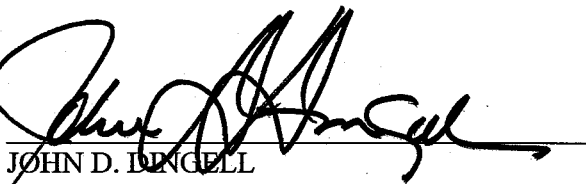
1. Does the Commission believe that Congress should address PUHCA repeal before pending investigations of Enron, including its own inquiry, have been completed?

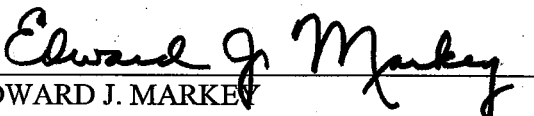
2. Does the Commission's reliance on existing financial disclosure requirements to offset risks posed by PUHCA repeal make sense in light of the concerns raised by your December 11, 2001, article in the Wall Street Journal, and the growing evidence of fundamental problems in the conduct of the accounting profession?
3. Has the Commission reconsidered its position on PUHCA repeal since Commissioner Hunt testified before the Subcommittee on Energy and Air Quality on December 13, 2001?
4. If not, will the Commission undertake a review of its position on PUHCA repeal in order to determine whether modifications are appropriate in light of the direct and indirect causes of the collapse of the Enron Corporation?

As various investigations into the Enron debacle proceed, we may have additional questions for the Commission. Thank you for your assistance.

Should there be questions concerning these matters, please contact us or have your staff contact either Consuela Washington (202-225-3641) or Sue Sheridan (202-226-3400) of the Committee on Energy and Commerce Democratic staff, or Jeff Duncan (202-225-2836) on Representative Markey's staff.

Sincerely,


JOHN D. DINGELL
RANKING MEMBER


EDWARD J. MARKEY
MEMBER

cc: The Honorable W. J. "Billy" Tauzin, Chairman
Committee on Energy and Commerce

The Honorable Joe Barton, Chairman
Subcommittee on Energy and Air Quality

The Honorable Rick Boucher, Ranking Member
Subcommittee on Energy and Air Quality